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Weekly Market Flash
Cautiously riding the risk asset rally

February 14, 2021

Equity markets posted moderate gains this week, following an explosive week and an exuberant start to the year. Major US indices continued to reach new highs, while European and international indices have recovered almost all of their losses since the onset of the pandemic. However, there is a strong sense of excess in the market, with most technical and sentiment indicators signaling caution.

Highlights

▪ Major US equity markets reach record highs, once again led by energy stocks. Companies continued to report solid earnings, with roughly four out of every five companies in the S&P 500 index topping earnings estimates – well above the norm.

▪ Deutsche Bank produced a study which found a number of encouraging signs for the deployment of the vaccine, including the potential for industrialized countries to complete vaccination of vulnerable individuals by April.

▪ Draghi finalized his list of Ministers this week, which included 15 politicians and eight technocrats. On Tuesday, he is due to face the Senate for the official endorsement.

▪ EUR/USD has bounced back to its trendline, after an attempt to break below its key support around the 1.1950-1.20 level in the previous week.

"Call option purchases have literally exploded – and Bank of America has sounded the alarm that fund underwriting has hit a record high..."

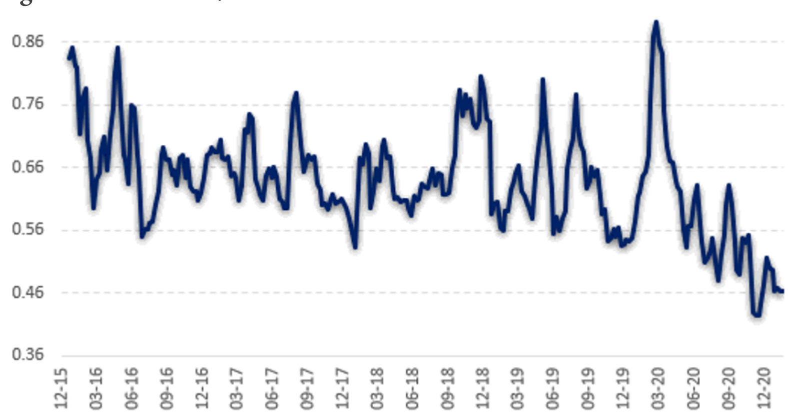
Markets & Macro | Cautiously riding the risk asset rally

Stimulus, central banks and vaccine progress support markets.

While equity markets have indeed witnessed an exuberant start to the year, there is a strong sense of excess in the market, with most technical and sentiment indicators signaling caution.

Call option purchases have literally exploded – and Bank of America has sounded the alarm that fund underwriting has hit a record high, while their proprietary sentiment indicator has come close to giving a signal that has produced significant corrections in the past (9% average decline over 12 signals). The CBOE put/call ratio has also gone back to previous lows in extreme territory.

Figure 1: CBOE Put/Call Ratio



Source: Bloomberg, as at February 12, 2021.

Our view: Were we in more "normal" circumstances, we would certainly move to the sidelines and protect our clients' portfolios. But without a clear new catalyst for a market correction, we prefer to remain fully invested and ride the rally in risky assets. Additionally, we have to consider the exceptional current financial and economic environment.

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We are facing a cyclical recovery linked to a (at least partial) normalization. We have just had USD900 billion of fiscal stimulus in the US from the previous administration, and we're close to the approval of the Biden administration's USD1.9 trillion of fiscal stimulus. We have the most expansive monetary conditions in history, with central banks committed to maintaining it for the foreseeable future, regardless of the path of inflation.

For example, US Federal Reserve (Fed) Chair Jay Powell held a very dovish speech this week. He did everything he could to encourage inflation expectations higher. However, the US is a long way away from a strong labor market, and even if the jobless rate does decline quickly, it doesn't mean the Fed will raise rates without realized and sustained inflation.

Meanwhile, on the vaccine front, things are improving fast. Deutsche Bank produced a study which found: 1) Industrialized countries should complete vaccination of vulnerable individuals by April. The number of available products and production capacity are growing. 2) The acceptance of the need to vaccinate by populations is higher than estimated. 3) New variants are not currently having perceptible impacts on vaccine efficacy in preventing severe symptomatic cases and hospitalizations. 4) Herd immunity will not be achieved until autumn, but it seems that in many countries, the idea of reopening once vulnerable groups have been immunized is gaining ground.

Corporate earnings have also been supportive for markets, posting an incredible season with positive surprises in the order of 18%.

Is the Italian asset rally sustainable?

This week, Mario Draghi finalized his list of Ministers, which included 15 politicians and eight technocrats. And on Tuesday, he is due to face the Senate for the official endorsement.

Our view: There are several reasons to think that the rally in Italian assets will be sustainable and durable across the year:

"Once Draghi is in charge with a solid team, with broad and unconditional support, the perceived Italian political risk will be diminished."

- Once Draghi is in charge with a solid team, with broad and unconditional support, the perceived Italian political risk will be diminished. This should offer guarantees of effective and credible programs and efficient execution, and will strengthen the bond with Brussels (and the ECB).
- The suspension of the stability pact, the temporary retirement of fiscal responsibility and the arrival of EU budget funds (all the more so with Draghi) means that for the first time in decades the executive has a lot of money to spend on investments. If in 2020 public spending went to plug the growth hole caused by the pandemic, from this year onwards it should be accompanied by a recovery in investments and private consumption, increasing its impact on the cycle.
- The Italian macroeconomic, political and epidemiological situation has likely kept foreign investors away from Italian stocks. If the expectations of normalization born following the advent of vaccines have perhaps produced a rebalancing, the political turnaround and the above-mentioned economic fallout should attract interest in a market that has so far remained on the margins of the investible universe.
- The Italian stock exchange has a reduced market capitalization (EUR550 billion) and low valuations compared to other stock exchanges. Many mid and small cap companies are hardly followed by the analysts of larger companies, and are almost unknown to international investors. For this reason, they have excessively low valuations. Against this backdrop, renewed international interest may have a stronger impact than elsewhere.

Equities | Energy sector drives US market to record highs.

Keeping our eye on European energy stocks.

"Market chatter also suggests that PIF, Saudi Arabia's sovereign wealth fund, has been disposing of European oil equities."

Major US indices were propelled to record highs this week, once again led by energy stocks.

Small and medium cap stocks widened their lead over large cap equities, and value stocks (primarily energy and financials) outperformed growth stocks. Companies continued to report solid earnings, with roughly four out of every five companies in the S&P 500 index topping earnings estimates, which is well above the norm.

Chinese equities also posted strong performance ahead of the Lunar New Year holiday. European equities were volatile, but closed the week higher.

Figure 2: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	31,458.40	1.11%	5.05%	3.00%
S&P 500	3,934.83	1.28%	6.01%	4.93%
Nasdaq	14,095.47	1.74%	7.88%	9.44%
Euro Stoxx 50	3,695.61	1.09%	6.26%	4.30%
FTSE 100	6,589.79	1.55%	2.85%	2.04%
CAC 40	5,703.67	0.78%	5.64%	2.89%
DAX	14,049.89	-0.05%	4.59%	2.41%
FTSE MIB	23,410.60	1.42%	8.52%	5.68%
Nikkei 225	29,520.07	2.57%	6.71%	7.57%
Hang Seng	30,173.57	3.02%	6.68%	10.81%
CSI 300	5,807.72	5.91%	8.52%	11.44%

Source: Bloomberg, as at February 12, 2021. Performance figures in indices' local currencies.

Elsewhere this week, the Bank of America Bull & Bear Indicator caught investors' attention as it climbed from 7.5 to 7.7 (the sell signal is above 8.0).

Our view: Year-to-date European energy stocks have lagged US energy stocks and oil. There are several reasons for the underperformance, including European majors' lower exposure to upstream crude production and their larger share of renewables versus their US peers. Market chatter also suggests that PIF, Saudi Arabia's sovereign wealth fund, has been disposing of European oil equities.

We expect the gap to narrow once the selling pressure recedes, and we look to take advantage of this situation by gradually adding exposure to European energy names.

"With most eyes on longer-dated bond yields... some may have missed that at the other end of the curve, yields are quietly drifting ever lower."

Fixed Income & Credit | Are investors seeking a short-term home for cash?

2-year UST reaches record low.

In financial markets, there is no bigger debate than the question on inflation. However, in January, inflation continued its great sleep: headline CPI rose 0.3% and 1.4% year-on-year. While we could be at an inflection point, the Fed remains comfortable extrapolating the past into the future and reiterating its commitment for maximum employment, while ignoring any emergence of measured inflation.

With most eyes on longer-dated bond yields – which reached 2% on Monday, thanks to upward pressure from the reflation trade – some may have missed that at the other end of the curve, yields are quietly drifting ever lower. Although inflation expectations for the next 24 months measured by break-even have picked up, the nominal 2-year US Treasury has tumbled to record lows hitting 0.10%.

Our view: The reasons can be two-fold. On one side, this confirms to the Fed that bond traders have clearly understood the commitment to keep rates low until inflation exceeds 2% and the labor market approaches full employment. On the other hand, it could be that investors are seeking a short-term home for a pile of cash that is expected to grow in the coming months, as the US Treasury Department makes use of its own mammoth cash balance, with hundreds of billions of dollars of stimulus spending.

Our view is that this cash avalanche, if it manages to spill out of the short-term Treasury market, will be an even bigger driver of market movements than central bank asset purchases.

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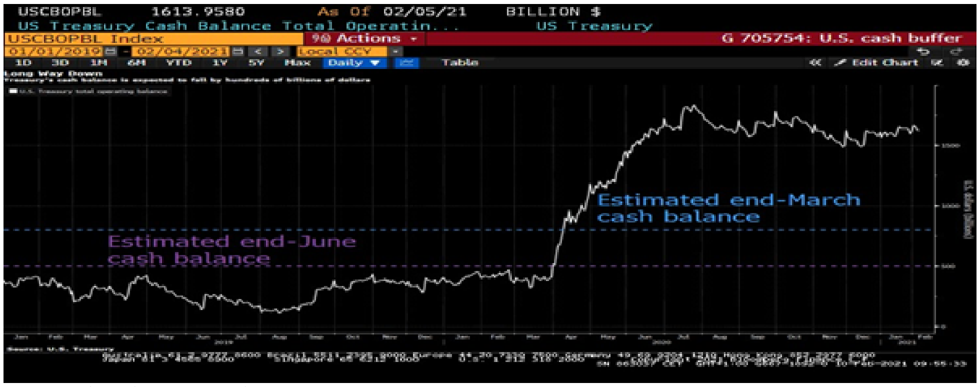
Figure 3: US Treasury Cash Balance



Source: Bloomberg, as at February 12, 2021.

FX & Commodities | Tailwinds for EUR/USD

FX pair set to reach high side of 1.20-1.25 range.

Chart of the week

EUR/USD has bounced back to its trendline, after an attempt to break below its key support around the 1.1950-1.20 level in the previous week. We think the conclusion of the USD correction, the better positioning after excessive USD shorts were cleared, and the improved prospects for Italy, warrant for a move to the high side of the 1.20-1.25 trading range.

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Figure 4: EUR/USD FX Pair

Source: Bloomberg, as at February 12, 2021.

Week Ahead | Key events to watch for

US financial markets will be closed on Monday for the Presidents' Day holiday.

- **The week will be packed with economic data releases**, including the release of the European flash PMIs for February, while in the US data releases for January include retail sales, industrial production, housing starts and building permits.
- **Attention will also focus on central banks** with the publication of minutes from the latest Fed and ECB meetings.
- **Developments on the government formation process in Italy** are awaited. The formal process needs to be complete, before Draghi can move forward with his ambitious agenda.
- **In terms of earnings**, with 369 of the S&P 500 index companies having now reported, only 54 companies will report this week.

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